RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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CORRECTION: THE LAST LETTER WAS ERRONEOUSLY NUMBERED 731. IT SHOULD HAVE BEEN 730.

June 1, 1978 **LETTER 731**

May 19, DJIA 846.85; PTI 813; A-D Ratio –17.66
May 26, DJIA 831.69; PTI 801; A-D Ratio –18.54

THOUGHT: On the recent rally, my indicators flashed the biggest "over-bought" market condition I have ever recorded. A friend asked me what I thought would follow. I answered, "Upside excesses lead to downside excesses. I believe between now and mid-1979, and very possibly this year, we will see one of the biggest "over-sold" markets on record. My work hasn't shown a classic over-sold bottom since late-1974. But I firmly believe it's coming."

THE PICTURE: I want to turn to a bit of classic Dow Theory. On May 17 the Industrials and Transports recorded rally highs (closes) of 858.37 and 231.25 respectively. A minor decline followed, and then a new advance. At this point something occurred which no one seemed to have noticed. On May 22 the Transports closed at 231.30, a new high. This new high was NOT confirmed by the Industrials Average (which closed that day at 855.42). At that point the Averages turned down.

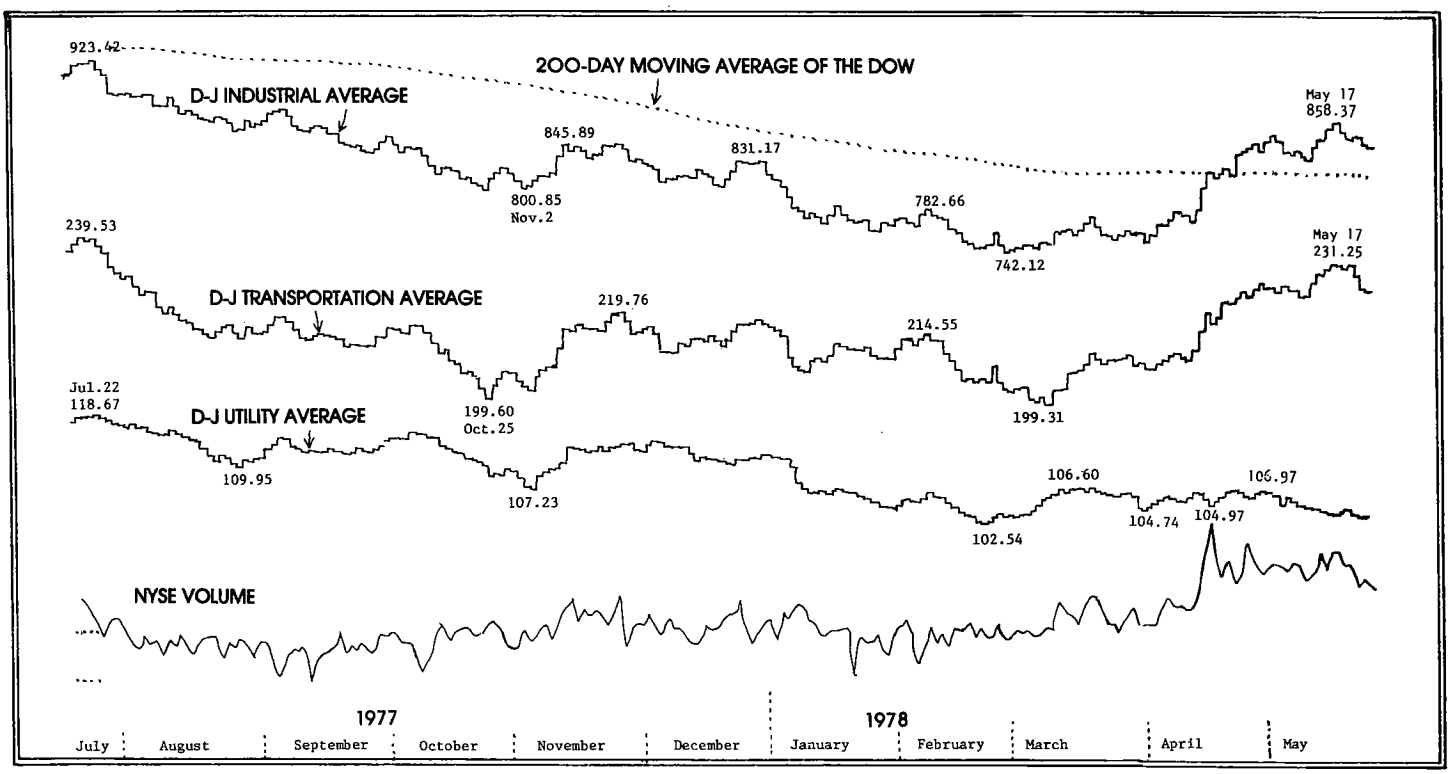
The Utility Average had chosen to ignore all the upside fireworks, and as you can see on the chart below this important (and usually leading) indicator is currently only a few points away from its bear market low of 102.54, recorded on February 22. I would regard a Utility closing below 102.54 as very bearish for the entire market.

From this writer's viewpoint, the rally since February 28 had many points of distinction. (1) It succeeded in turning many investors bullish within a matter of weeks. (2) It produced record NYSE volume. (3) It was accompanied (incredibly) by a vicious slide in bonds. (4) It was based in large part on a stronger dollar and heavy foreign buying. Ironically, nothing has occurred on a fundamental basis to produce a lasting stronger dollar. Furthermore, I know of no instance in market history where foreigners were lucky enough or astute enough to buy at a major market bottom.

Now let's turn to a different aspect. The following is an impartial (as impartial as I can be) appraisal of the Dow under the 50% Principle. From its September 21, 1976 peak of 1014.79, the Dow declined with almost no interruption to a February 28, 1978 low of 742.12. This represented a drop of 272.67 points. The halfway or 50% level of this entire decline is 878.66. This 878.66 level is an interesting one under the 50% Principle (a concept that I have often written about).

The rally to May took the Dow to 858.37, 20 points under the 50% level of the preceding decline. The greatest volume in history accompanied the advance, yet the Dow could not negotiate the 50% level. In view of that volume, I fail to be impressed with the rally. However, to give the bulls their fair due, if the Dow can push decisively above the halfway level (878.66), then I would think the Dow could push considerably further and perhaps test its own high. However, if the rally has topped (or will top) below the 878.66 level, then I believe we will see the lows tested in due time.

One fascinating aspect of the advance was that the advance-decline ratio on May 17 came within eleven one-hundredths of bettering its July 2, 1977 bull market high. But at that crucial point, the A-D turned down. Since the downturn came on lower volume, I have been recording new lows on my negative volume



index (see Letter 729, page 3). Such action of course, represents poor technical action for the market.

For those who closely follow my studies of the Dow moving averages (see Letter 728, page 3), the 50-week MA of the Dow is now 826. The 13-week MA now stands at 792. This means that the distance between the two MA's is now 34 points (34 points short of a buy signal).

I want to make a few further comments regarding the action during the rally. First, the rally took place in two "parts." The first advance took the Dow from 742 to 775 on relatively normal volume. However, the second part of the move began on April 13 at 775 on the Dow. On April 13 NYSE volume surged to 31 million shares and volume remained at over 30 million shares on the rest of the rise. In fact, average volume after April 13 averaged 40 million shares, the biggest volume area in the history of the New York Stock Exchange (see page 1 chart).

One reason volume was so high was that the buyers were absorbing huge amounts of stock that were offered for sale. Let's look at it this way: the rally from 775 (April 13) where the big volume started, to 858 was 83 Dow points. Volume during that rise totaled 1.008 billion shares or 12 million shares per Dow point! That is an enormous amount of volume (steam) under the boiler to lift the Dow each extra point. Whether this kind of volume can be sustained, assuming the Dow tries to push further, is doubtful. At least this writer is skeptical about a return to massive, upside volume. I believe the advance to 858 used up the great bulk of the buying power and that the buying power as of May 17 **was exhausted.**

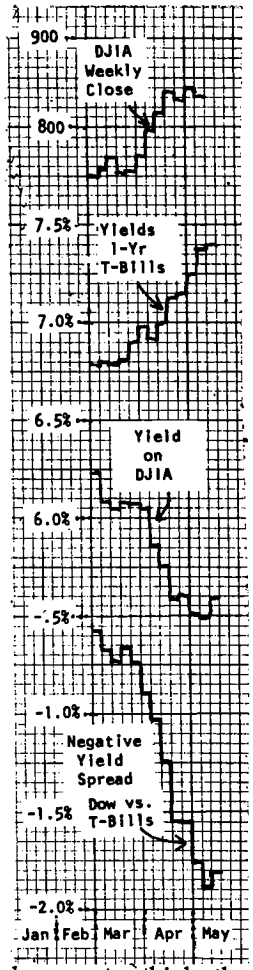
Here is another point that I made in the last Letter, but it is a point that I want to repeat. The over-30 million share volume began on April 13 (Dow 775) and it lasted to May 17 (Dow 858). The *average price* of the Dow during those 21 huge volume days was **825.40.**

If the Dow now drops below 825 it would mean that the Dow was selling below its average price for the whole high-volume portion of the rally. I would therefore take a most bearish view of any decisive break below 825. A break under the 825 level would mean that we were seeing the beginning of a "lock-in" of over 1 billion shares of stock. My guess is that such action would mark the beginning of the end for this bear market rally.

So much for stock market action, but there is another area I want to discuss. And this area concerns interest rates. I have written so much about bonds and interest rates lately, that subscribers must be weary of it. But nothing is more crucial to the market, and I wanted to include this paragraph from the *Bank Credit Analyst* of May (1245 Sherbrooke St. West, Montreal, Canada). *"No bull market in the last 75 years has developed without a cyclical decline in interest rates . . . it is likely that interest rates will move substantially higher before they peak .... Historically, bear market rallies that have occurred while interest rates have continued to rise have usually been followed by particularly vicious declines.*

For my own interest (and I hope the interest of subscribers) I drew a chart showing the Friday closings since early March, the yield on the Dow, the yield on a widely-watched Treasury instrument (the 1-year Treasury bill), and finally, the differential between the Dow yield and the 1-year Treasury bill yield. This last (the lowest line on the following chart) is representative of the pressure on stocks in terms of negative yield factors.

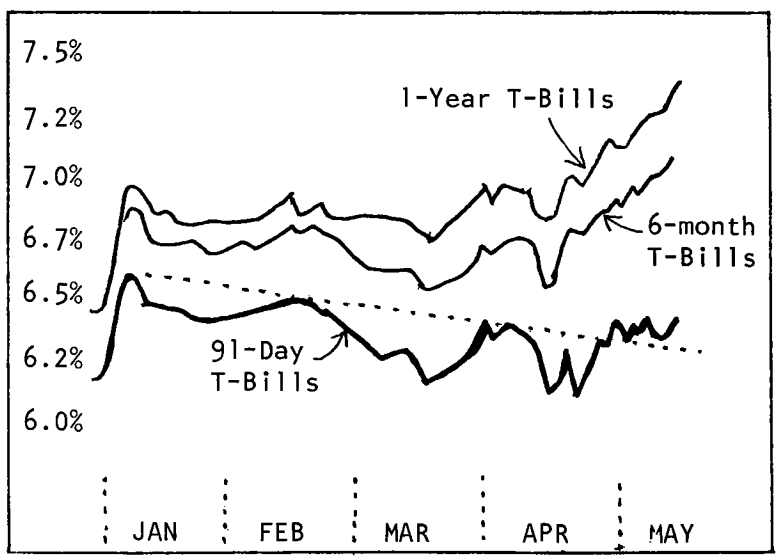
The extraordinary thing about the stock market rally which began on February 28 is that **it took place in the face of a falling bond market and higher interest rates.** The implications of this unorthodox action are financial dynamite. **The** reason I say that is that while the Dow rallied (producing lower Dow yields) the bond market was falling (producing higher bond yields). The result was an **explosion in the negative stock-bond yield spread.** Study the chart. Within a matter of 12 weeks (March 3 to May 19) the negative yield spread between 1-year T-bills and the Dow widened from minus .57 to minus 1.88 in favor of T-bills. The negative yield spread tripled in those 12 weeks!



I have written before that the stock market can adjust to any level of interest rates, but it cannot adjust to a steady rising level in interest rates. There is a fascinating puzzle in this picture. Almost everyone has been talking about "higher interest rates." Now there's nothing new or original about that thought (although some are saying that interest rates will peak this summer or even sooner). Therefore, I say to myself, "What's the contrary opinion? It's got to be that interest rates have just about peaked–or that interest rates are going *much higher* than anyone expects." I happen to think the latter is going to be the case!

I'm including a second chart because I think this money situation is so **crucial** and because I believe it's moving so **fast.** This chart shows the rates on the 1-year T-bills, the 6-month T-bills and the widely-followed 91-day T-bills. The *disparity* is rather striking. What has happened is that big money has been opting for utmost safety, and that safety is the 91-day T-bill, the *shortest* of all Government debt securities. Thus, the heavy buying of 91-day T-bills has tended to hold rates down on these particular instruments.

On top of this, the Fed has been coming into the market buying up Government securities. Obviously, the Fed is afraid of interest



rates running through the roof. But despite everything, the pressure on the money markets is proving too strong. On May 23 the 91-day T-bills jumped to 6.5% yield, the highest level since December 2, 1974.

How high could money rates go? No one knows. But in 1974 Fed funds went over 12 %, the prime rate went over 12%, and 91-day T-bill yields rose to over 8%. The current rise in yields started from a much higher base. Therefore, it would not surprise me (if bank loans continue to rise) to see money rates ultimately go over the 1974 peaks. As I see it, the Fed has two choices in the current situation: the Fed can let money rates "go through the roof" or the Fed can open the spigots and let a torrent of money sweep over the markets in an effort to keep interest rates down. The latter, of course, would be highly inflationary (and it could be one reason why gold has been rising WITH the stock market).

"THE WHIRLING CIRCLE:" I have been stressing for over a year the point that "investing" in the time-honored sense of the word is almost a thing of the past. The operative word today is SURVIVING. With all market movements *accelerating*, with the long-term capital gains period stretched out to one year, with high taxes (up to 70% on unearned income), the average investor has now (by necessity) become a survivor. He is literally a fugitive running from government taxes, edicts, red-tape and regulations.

On top of this, we have the unique situation today of being a nation that is pumping up its money supply (inflating and attempting to increase liquidity) while at the same time building greater and greater debt (which is basically deflationary and tends towards illiquidity). Thus, the US is straining under the influence of two opposing forces, liquidity via Fed pumping and illiquidity via rising debt and service costs on that debt. The situation can best be likened to a man who is drinking cup after cup of strong coffee while at the same time taking depressant pills.

I have been thinking for some time about the US economy and its stock markets in terms of a "frantic whirling circle," a sort of economic snake that is eating its own tail. Then a few days ago, while staring at the monthly chart of the Dow, I was fascinated to note that the pattern of the Dow ever since the 1966 bull market top, had literally taken the form of a giant, fantastic circle! I immediately drew in this circle with a compass (see chart).

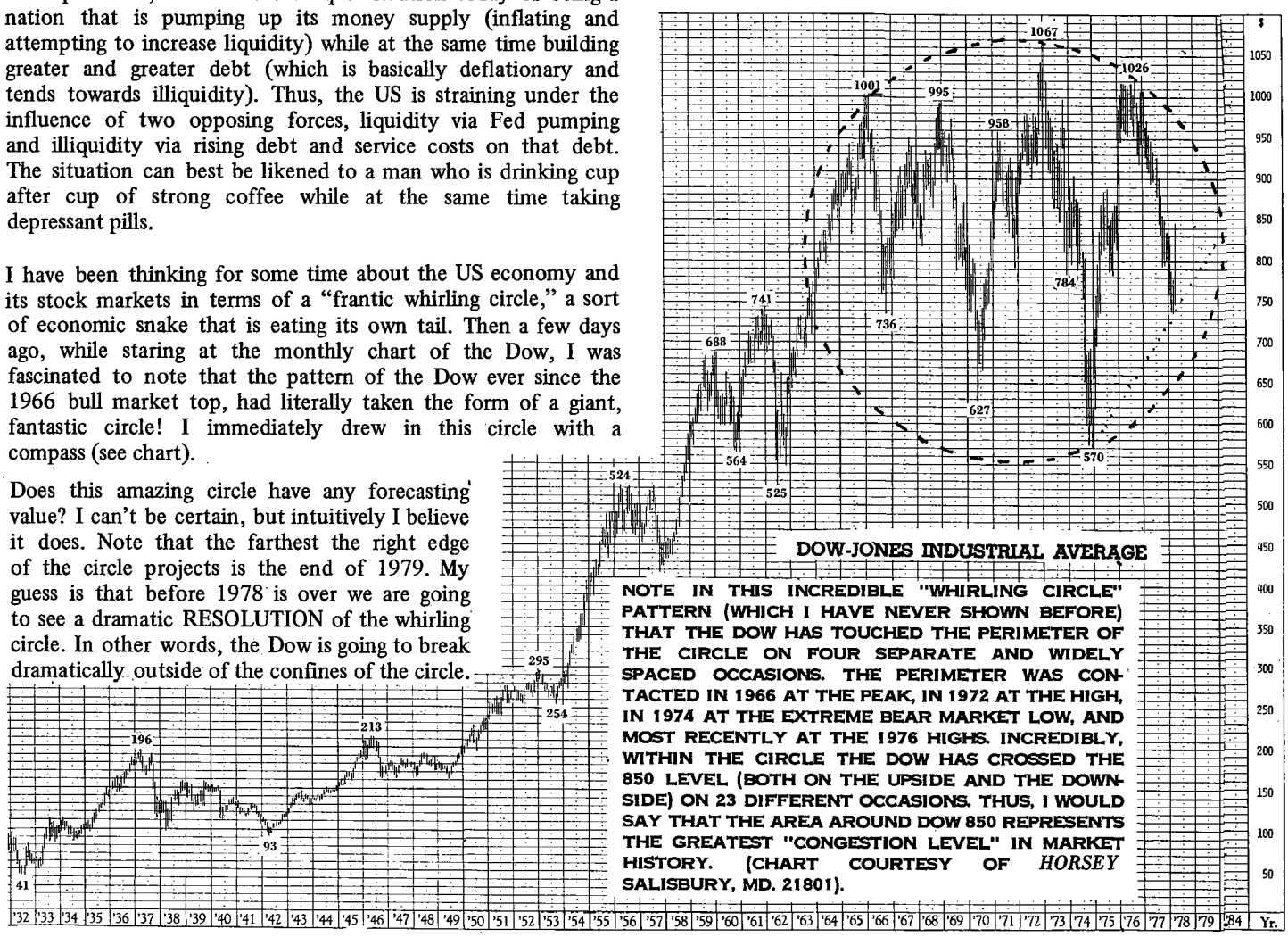
Does this amazing circle have any forecasting value? I can't be certain, but intuitively I believe it does. Note that the farthest the right edge of the circle projects is the end of 1979. My guess is that before 1978 is over we are going to see a dramatic RESOLUTION of the whirling circle. In other words, the Dow is going to break dramatically outside of the confines of the circle.

The next question is "Which way the breakout?" My own gut feeling is that it will break down, but there is no way of telling at this time. A trendline drawn through the 1973 and 1976 peaks now comes in at about 1000. If the Dow were to rally above the upper circle limits (about 975 and then above 1000) it could be that we would be seeing the beginning of the greatest inflationary blow-off in Wall Street annals.

On the other hand, if the Dow were to drop below a trendline connecting the 1974 low of 577 and the 1978 low of 742, in other words, a drop below around 750, the situation would appear ominous. A further drop below the circle confines at around 650 would then probably precipitate (or predict) the first all-out deflationary collapse since the 1930's.

I view this circle as the greatest and most intense period of stock market "congestion" in history. It's a period wherein the forces of inflation have confronted the forces of deflation (brought on by a massive debt structure which is eating up savings, capital, incomes, the will to produce). In my opinion, the resolution of this extraordinary period of stock market confrontation may shape our lives for years to come.

NOTES AND QUOTES: COMPOUNDING: For years I've been telling my readers about the power of compounding money. For instance, at the current 8.5% that long-term Government bonds now offer, your money doubles in 9 years. At the current 9.75% offered by many bonds and preferreds, money doubles in 8 years. Pacific-American Income and Current Income (two of the many closed-end bond funds listed on the NYSE) now yield close to 10%. At 10% money doubles in less than 7 years.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DOW-JONES INDUSTRIAL AVERAGE
NOTE IN THIS INCREDIBLE "WHIRLING CIRCLE" PATTERN (WHICH I HAVE NEVER SHOWN BEFORE) THAT THE DOW HAS TOUCHED THE PERIMETER OF THE CIRCLE ON FOUR SEPARATE AND WIDELY SPACED OCCASIONS. THE PERIMETER WAS CONTACTED IN 1966 AT THE PEAK, IN 1972 AT THE HIGH, IN 1974 AT THE EXTREME BEAR MARKET LOW, AND MOST RECENTLY AT THE 1976 HIGHS. INCREDIBLY, WITHIN THE CIRCLE THE DOW HAS CROSSED THE 850 LEVEL (BOTH ON THE UPSIDE AND THE DOWNSIDE) ON 23 DIFFERENT OCCASIONS. THUS, I WOULD SAY THAT THE AREA AROUND DOW 850 REPRESENTS THE GREATEST "CONGESTION LEVEL" IN MARKET HISTORY. (CHART COURTESY OF HORSEY SALISBURY, MD. 21801).
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That's the plus side of compounding interest. I've also warned that this nation is running accelerating deficits at steadily increasing interest rates. That's the sure, absolutely certain road to bankruptcy. The reason is that the nation is now operating with the power of compounding working AGAINST it. Thus, the debt the nation owes increases each year and the day of ultimate bankruptcy grows nearer. What is bankruptcy? In this day and age, it's the time when you can't pay the interest on your debt!

In California, mortgage money is now going at 9½ to 10%. Here's what that means. At 9½% if you pay off your mortgage on a monthly basis, by the end of 20 years you will have paid back $2,239 for each $1,000 you borrowed. At 9½% if you pay off monthly on a 30 years basis, by the end of the 30 years you will have paid back $3,028 for each $1,000 you borrowed. That means that (on a 30 year basis at 9½%) if you buy an $80,000 house with $20,000 down, by the end of 30 years you will have paid $201,000 for your house! That's the power of compound interest working against you!

* *

PROPOSITION 13: The radios ring with talk about it, the ads herald it, the talk everywhere in California is about Proposition 13, the proposed law that would limit property taxes. Every politician here is running on a "for it" or "against it" basis. I think it's going to pass. I believe it will pass because everyone I talk to says, "I don't like it, but I'll vote for it," or "I like it and I'm going to vote for it." One fellow made the comment that stuck most firmly in my mind. "I don't even own a house, but I'm for it. It's the first chance I've ever had to kick the government in the butt!" And that's the sentiment out here.

I think the implications (if 13 passes) are explosive. Other politicians in other states will formulate tax-ceiling bills or spending ceiling bills. The people have been fed up for years, but they haven't figured out how to stop government in its tracks. Proposition 13 (which is far from perfect) is lighting the fire. People are learning–you stop government through legislation. You vote for the man who proposes or backs the legislation. But here's the big point: for the first time the politicians are feeling the grass roots anger and seeing the political plusses in the "stop the spending through legislation" bills.

The politicians are reacting. Governor Brown has panicked and has ordered a rollback (which is illegal) in property taxes out of hand. Other politicans are warning via radio that 13 will throw government into chaos, that it will collapse the states spending capabilities. "You idiots," I say to myself, "that's exactly what the voters want to do." Next stop–Washington.

* *

THE BATTLE for money continues, and the thermometer of the fever is interest rates. US Trust sees the demand for new credit skyrocketing almost 16% to $460 billion from last years $396 billion. And the biggest competition for new money is going to come from the US Government, which (with its various agencies) is going to raise $82 billion in new money this year, up 28% from the $64 billion of last year.

In the face of this astronomical demand for money, the Fed will have to deal with inflation (which is probably running at a double-digit basis right now). The fierce competition for money on the savings institutions level can be seen in the fact that the S&L's are now allowed to issue 6-month certificates at ¼% over the prevailing T-bill yields. But I do not think this is going to stop disintermediation (an exiting of money from the savings institutions).

In fact, I think we are moving into one of the most competitive situations ever seen for possession of new money. And the consumer, now far more sophisticated than before, is going to opt for the best and safest deal. I remember 10 years ago I had to explain to our local bank manager what a Treasury bill was and how to buy it. Now the butcher and the baker know about T-bills and C/D's and bonds. It's going to be a lot harder for the banks to keep the money in the savings accounts, and that means the offers and enticements will have to be more attractive than ever. All this increase in the cost of money is inflationary in that it raises costs. Ultimately, it will be deflationary in that it kills business.

* *

By the time you read this I will be in Nassau at the largest off-shore monetary conference ever given (750 people). I should have a good chance to meet with friends and buddies such as the two Harries (Schultz and Browne), and many other experts in the field of finance. I hope to pack my brain with some new ideas and concepts. I'll also have a chance to meet with many of my own subscribers.

* *

Some subscribers may wonder why I have talked so much about money in this report. The answer is that money runs the physical (not the spiritual) world, and it also runs the markets. Money can only do a few things. It can be more or less available. And it can cost more or it can cost less. But I find that of all the areas of finance and business, the one least understood by amateurs and professionals is money. (Although people now do understand the concept of shopping for the highest and safest interest rates). The whole area of money is the one that took me the longest to learn about (and I'm still learning).

* *

The speed with which the whole inflation-monetary scene is now developing is what is amazing investors. On the single day of May 26 the Wall Street Journal carried the following stories. (1) Ginnie Mae, for the first time in history, turned down all bids for its mortgages. The bids were "too low." Prognosis: mortgage rates are heading higher. (2) Continental Illinois bank raised its prime rate to a new high of 8.5% (the rest of the nation's banks are now following). (3) The WSJ ran a front page story on food prices, stating that many economists believe that prices for food are going much higher than the Government foresees. Conclusion: more and higher inflation. (4) The dollar dropped sharply against the Swiss franc and the yen. The opinion is that the dollar rally against the yen is over.

(5) Most important of all, in my opinion was a story on a William Miller (Fed chief) conference. Miller stated that if the Government doesn't cut down on spending and move toward a low deficit by 1981-82, the Fed will be forced to tighten the screws, tighten even though it may throw the nation into recession. I've said this from the beginning. Fed chief Arthur Burns was all talk, but in actuality he resided over the biggest monetary inflation in US history. I believe Miller is going to prove to be one tough cookie, and I believe he means what he says. He's the only strong man in this Administration (although technically the Fed is not part of the Administration). Miller sees what is happening, and he's moving and he'll move further. The general feeling on Wall Street is that Miller will cave in if business buckles under tight money. We'll see.

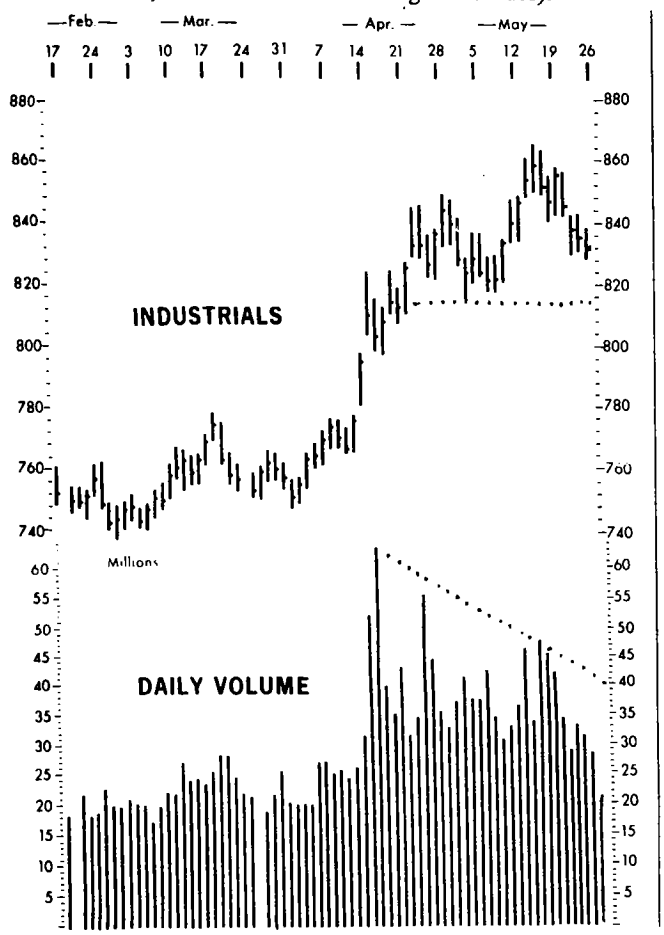
* *

OUR HOME is two blocks from the ocean, and often I drive or walk along the famous "Wind 'n Sea Beach" which is on the way to my office in La Jolla. Today I leave for work at 6 a.m. and I drive slowly along Wind 'n Sea because it's always an inspiring sight. The glassy California waves are rolling in, and there are a dozen surfers cavorting about a hundred yards off shore (yes, I'm talking about 6 in the morning). A few joggers are trailing along the beach, and the sun is just coming up, shimmering on the foam of the waves. It makes me feel good to be alive. And it puts everything into perspective.

I realize that long after I'm gone, long after the stock market is gone, long after everything I see that is man-made is gone, God's ocean and his waves will be rolling onto the shores, exactly as they are doing now. I guess such thoughts give me strength. How can you take yourself too seriously (or take the world too seriously) when you are watching those waves as the sun rises?

LATE NOTES: I don't think I've ever seen the daily new highs and new lows *switch* so quickly after a market peak. Five trading days after the rally peak, on May 26, new lows suddenly took dominance over new highs on the NYSE. The new highs and the buying power just seemed to fizzle.

I'm including a daily chart of the Dow and volume taken from the WSJ. The chart interests me. If the Dow were now to move down to the 820 area or below (in the vicinity of the horizontal dotted line), we would have a very clear potential for a "head-and-shoulders" top in the senior Average. Volume has been dribbling away as you can see on the chart, and thus volume implications are correct for the formation of a H&S top (during such a pattern volume should be highest on the left shoulder, less at the head, and even lower at the right shoulder).



At any rate, if the Dow now drops back to around 820, then mounts a weak rally from that area, I would guess that we had seen a tremendous mass of distribution and that a top had been formed in the Dow. Of course, I have to tell myself that not all Richard Russell's chart visions come to pass. But I thought the picture was interesting enough to bring to the attention of subscribers. I don't have to tell you that if the Dow does form a H&S top and it does then break down, the market picture is going to be bearish, very bearish indeed.

GOLD: Figures for the April US trade balance were just released. The balance was $2.9 billion in the red, fifth worst monthly trade balance in history. The dollar has weakened against hard currencies again, and strong men with strong stomachs ask themselves, "What's changed?" The answer is that nothing fundamental has changed. The US continues to spend more than it makes, buy more than it sells, consume more than it needs, and waste more than it saves.

Meanwhile, gold is hesitating at an interesting (though not necessarily crucial) juncture. Gold's 4-week moving average (MA) is now 176.45 (see chart at bottom of p.6). Gold pushed above its 4-week MA in mid-May and is now trending higher. So far so good.

The longer 13-week MA of gold is now at 178.50. What happens next? The "ideal" action, from a technical standpoint, would be a dip to 175-77 (in the vicinity of the 4-week MA), then a decisive rally above the 13-week MA into the 180's.

On the page 6 point & figure chart you can see that gold has a somewhat difficult problem at present. There is a good deal of technical congestion in the 178 to 183 area, the area I have marked with an "X" on the chart. In order to put on a really bullish performance, bullion will have to advance above this area into the mid-180's. At that time (assuming this action materializes), gold will be in the position to try for the 190 high recorded in March of this year.

Now every chart reader and investor who's worth his salt is mortally afraid of the so-called "double-top." A double-top would occur if gold pushed up to around 190, then fell back, then tumbled. Will that occur? No one knows. My own feeling is that gold may not be ready for the big move through 190, at least not at this time. To be honest, I have no firm conviction or great feeling that "the big move to new highs" lies just ahead. I do think that in due time gold will cost a lot more in terms of dollars and other paper money, but the question is–is gold ready to move up now?

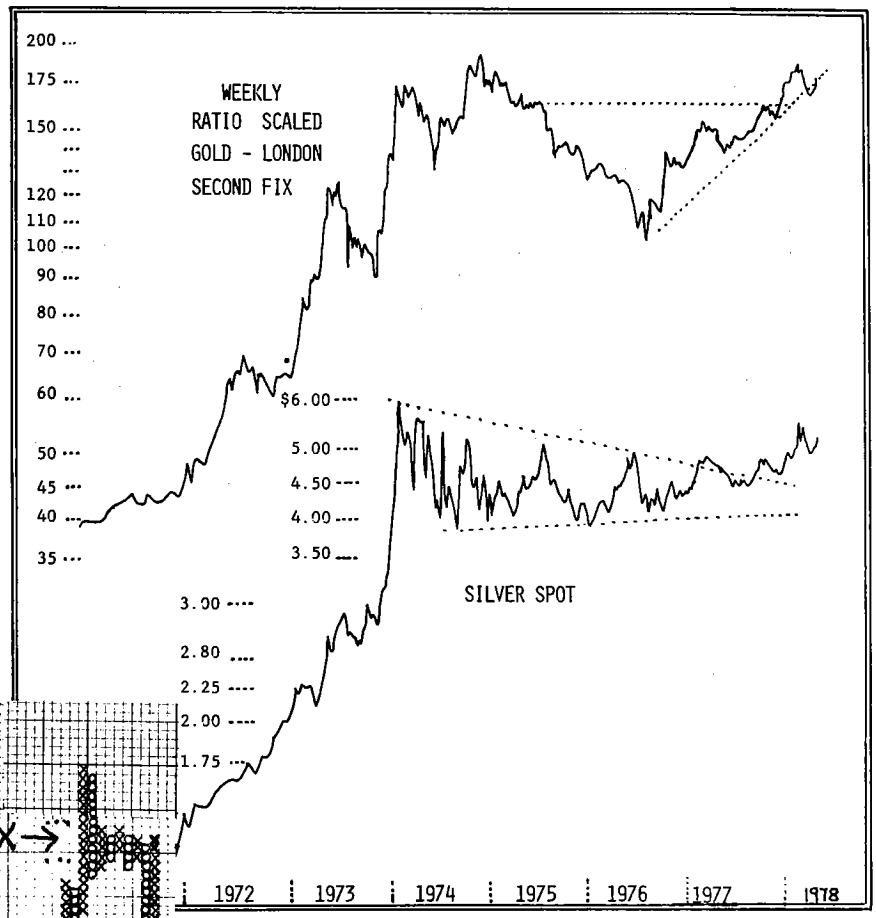
I have two overviews about gold. The first is that we are now working on the right shoulder of a giant head-and-shoulders BOTTOM in gold. The formation is very large, but it can be easily seen on the point & figure chart. The right shoulder has not yet done much "work," and by that I mean that a lot more fluctuating and backing and filling could be ahead (it doesn't have to work that way, but it could). In view of this, I would not be particularly worried about gold if it dropped back, floundered around, went nowhere for a while.

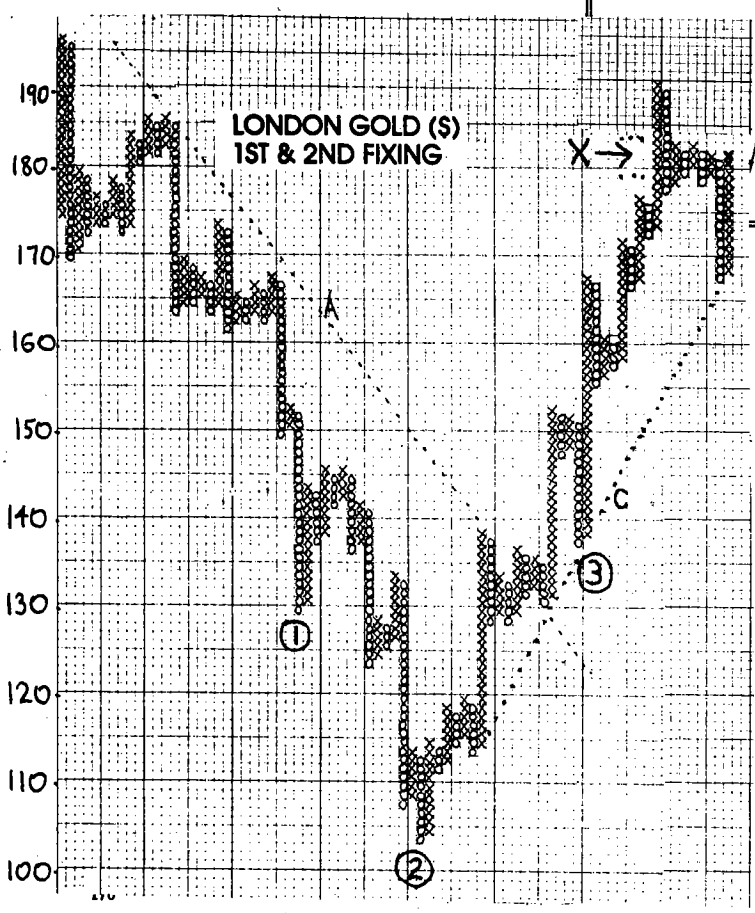
The second overview is that the 50-week MA of gold (heavy line at the bottom of the p. 6 chart) represents the primary trend line for gold, and this line has been moving steadily higher while everyone has been wringing their hands about every point up or

down on gold. The 50-week or primary MA is now at a new 1977-78 high of 162.75–and it creeps higher weekly. My own instinct is to hold my gold as long as the 50-week MA pushes North.

I do not feel that gold is in a good area at this time for the speculator. In other words, for those of us who have purchased our gold at lower prices, I consider that gold a good holding and a good "insurance policy" at this time. For the trader (say a person who wants to buy futures) I feel gold is in a very tricky area. It could drop back, it could form a double top and drop back, or it could break out above 183 and try for 190. Personally, I don't care what it does, but if I had to bet I would say that 190 will be bettered by year-end.

The long-term ratio chart at the top of this page shows gold and silver on a comparison basis. Silver, like gold, seems to be moving its "floor" slowly and relentlessly higher, and it would seem that "under $5" silver has just about disappeared.

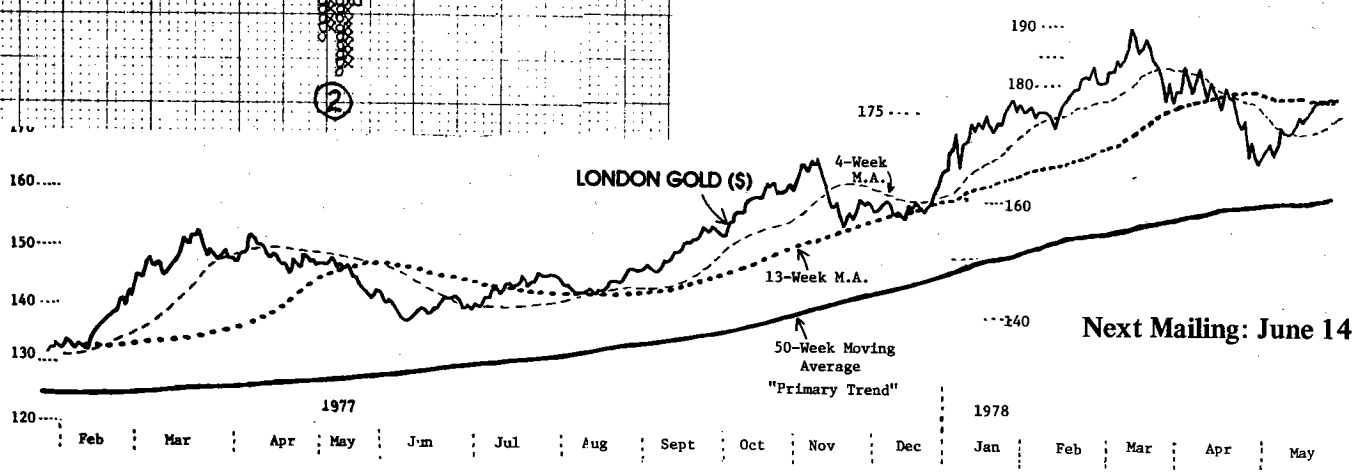




I would say that "under $160" gold has disappeared as well. For months some soothsayers have expected an upward explosion in the metals while others have predicted a collapse. The two metals have been grinding higher, frustrating the bears and causing the bulls to become impatient. So far, I like the action on both metals.

FINAL THOUGHT: The nation is now indulging in the greatest gambling orgy I have ever seen. From all reports, people are lined up at the new Atlantic City Casino, waiting patiently to be parted from their money. Reno is on a building jag and threatens to overtake Vegas. The gambling stocks are all over the most-active list. What's happening is that the return of double-digit inflation has produced a psychology of "I might as well try to double it because inflation will wipe it out or the government will take it anyway."

We see the "double or nothing" psychology in the new options markets and in the booming interest in commodity speculation. Everybody wants to beat the market. It's the new game in town. As a result, the various markets are becoming ***harder*** and ***harder to actually beat***. Long-term capital gains are becoming a rarity. But the stock market beast loves what it sees. The PRESSURE to beat the market on every swing, makes it easier for the market to beat the speculators–and it will!



Next Mailing: June 14